DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0304
Indiana Corporate Income Tax
For the Tax Years 1996, 1997, and 1998

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Excess-Value Reinsurance Premiums – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(l); Gregory v. Helvering, 293 U.S. 465 (1935); Horn v. Commissioner of Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992).

Taxpayer challenges the audit's decision to adjust its Indiana tax returns to include, as taxpayer's own income, reinsurance premiums received from its customers and ultimately paid over to a foreign insurance company directly or indirectly associated with the taxpayer.

II. Combined Water's Edge Unitary Return.

Authority: IC 6-3-2-2(o); IC 6-3-2-2(q); IC 6-3-2-2.4; Securities Corp. v. Dept. of State Revenue, 704 N.E.2d 1122 (Ind. Tax Ct. 1998); Ind. Dept. of Rev. Tax Policy Directive No. 6 (1992).

Taxpayer maintains that the audit erred in denying it permission to report its business activities on a "world-wide" unitary basis and the audit's consequent exclusion of net income attributable to taxpayer's foreign subsidiaries.

III. Unitary Partnerships – Adjusted Gross Income Tax.

Authority: Allied-Signal Inc. v. Dir., Div. of Taxation, 504 U.S. 768 (1992); Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983). F.W. Woolworth v. Taxation and Revenue Dep't of New Mexico, 458 U.S. 354 (1982); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982); Exxon Corp. v. Dep't of Revenue of Wisconsin, 447 U.S. 207 (1980); Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425 (1980); 45 IAC 3.1-1-153(a), (b).

Taxpayer contests the audit's determination that five partnership entities were "unitary" with the taxpayer.

IV. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that the ten-percent negligence should not have been imposed and that the Department should exercise its discretion to entirely abate the penalty.

STATEMENT OF FACTS

Taxpayer is in the business of shipping packages and is the primary operating subsidiary of the parent company. The taxpayer filed Indiana tax returns which included its various domestic and foreign affiliates. The Department of Revenue (Department) conducted an audit of taxpayer's business records and tax returns spanning the years 1996, 1997, and 1998. The audit made a number of adjustments certain of which resulted in the assessment of additional Indiana corporate income taxes. Taxpayer submitted a protest challenging a number of the audit's determinations, an administrative hearing was held, and this Letter of Findings follows.

DISCUSSION

I. Excess-Value Reinsurance Premiums – Adjusted Gross Income Tax.

Taxpayer earns money by shipping packages. If one of a customer's packages is lost or damaged during shipping, taxpayer will automatically pay the customer up to $100 of the package's declared value. If the customer wishes to insure a package worth more than $100, taxpayer will do so and charge an additional amount for each additional $100 in declared value. This additional amount is called an "excess value charge." The amount taxpayer is entitled to charge for excess value insurance is governed by various federal and state tariffs.

At one time, taxpayer simply retained these excess value charges and paid for any losses out of its corporate pocket. The difference between what the taxpayer charged as excess value charges and the amount it paid as losses was simply retained as one portion of the taxpayer's profit.

Taxpayer rearranged its business organization to minimize the potential tax effect on profits derived from insuring its customers' packages. It did so by forming and capitalizing a Bermuda corporation. Thereafter, the Bermuda corporation's shares were distributed to taxpayer's own shareholders; the Bermuda corporation's shareholders were essentially identical to taxpayer's own shareholders.

Subsequently, taxpayer purchased an insurance policy – on behalf of the excess value insureds – from a domestic insurance company. The domestic insurance company assumed the risk of damage or loss to excess value packages. However, taxpayer agreed to administer the day-to-day claims submitted by taxpayer's insured customers.

The domestic insurance company then entered into a reinsurance treaty with the Bermuda corporation. The Bermuda corporation agreed to assume the entire amount of risk borne by domestic insurance company and owed to taxpayer.

Under this new arrangement, taxpayer collected the customer's excess value insurance payments, investigated any insurance claims, settled for any verified claims, and then paid over the remaining premium amounts to the domestic insurance company. The difference between the amount of money taxpayer received from its customers and the amount of money taxpayer paid for losses to excess value packages, constituted the premiums on the policy with the domestic insurance company. Therefore, depending on the amount of claims paid to its customers, the premium amount paid over to the domestic insurer would vary from month to month.

The domestic insurer collected the premiums, retained a portion of the premiums for its own fees, commission, and taxes and forwarded the remainder of the premiums to the Bermuda corporation as consideration for the reinsurance agreement. In practical application, the domestic insurer paid approximately 95 percent of the premiums received from the taxpayer over to the Bermuda corporation.

Taxpayer did not report on its federal return the amount of excess value insurance premiums it received from its shipping customers. The Internal Revenue Service disagreed with this decision and determined a deficiency equal of the value of the excess value charges taxpayer collected. The Internal Revenue Service found that the value of the excess value charges should be treated as taxpayer's own gross income. Taxpayer appealed the IRS finding. In a 1999 Tax Court Memo, the United States Tax Court agreed with the IRS determination and concluded that taxpayer's insurance arrangement was a "sham." Subsequently, taxpayer appealed the Tax Court's decision to the federal court of appeals. In 2001, the court of appeals reversed the Tax Court's decision and remanded the issue to the Tax Court in order to allow it to address the IRS's contentions challenging the reinsurance arrangement under I.R.C. §§ 482, 845(a).

The total amount of excess value charges was reported on the taxpayer's 1998 federal tax return. During the state's own audit of taxpayer 1996, 1997, and 1998 state returns, the amount of excess value charges reported on the federal return was included as one of the state adjustments on the 1998 Indiana return. In addition, the audit included "projected amounts" of these premiums for the 1996 and 1997 in those amounts to be apportioned to the state.

Taxpayer challenges the audit's determination as both inappropriate and premature. According to taxpayer, following remand to the Tax Court, taxpayer entered into discussions with the IRS in order to achieve a compromise settlement. Taxpayer urges the Department to hold the assessment of additional taxes – based upon the income received from excess value premiums – in abeyance until the compromise settlement with the IRS has been finalized.

The "sham transaction" doctrine is well established both in state and federal tax jurisprudence dating back to Gregory v. Helvering 293 U.S. 465 (1935). In that case, the Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id at 470. The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand

them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied,* 338 U.S. 955 (1950). "[t]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Commissioner of Internal Revenue, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, *ex ante,* for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" Id. at 1337.

In applying these standards to the particular insurance arrangement taxpayer entered into with the domestic insurer and the Bermuda corporation, the Department concludes that the arrangement comes within the definition of the sham transaction doctrine. It is apparent that the reinsurance arrangements were entered into for no independent purpose other than obtaining the tax benefits attendant upon those arrangements and that it is the taxpayer who is earning this money and not the domestic insurer and not the Bermuda corporation.

Under the reinsurance agreements, taxpayer collects the excess value premiums from its customers, deposits the premiums into its own accounts, receives and processes the claims, pays for losses incurred as the result of damaged or missing excess value packages, and pays the amount remaining to the domestic insurer as "premiums." The domestic insurer thereafter – after retaining approximately 5 percent of the amount – passes the premiums over to the Bermuda corporation which is entirely owned by taxpayer's own shareholders. As between taxpayer and its shipping customers, the insurance agreement is entirely transparent.

The domestic insurer's only risk exposure is in the event of the sort of catastrophic loss for which taxpayer provides no material evidence or historical experience. In any event, this negligible risk of catastrophic loss is simply shifted from taxpayer, to the domestic insurer, to the Bermuda corporation and – ultimately – the Bermuda corporation's shareholders. By the terms of this roundabout insurance arrangement, the risk of catastrophic loss finds its way back to the same shareholders who bore it in the first place. Taxpayer is paying substantial amounts of money for little discernible benefit and its arguments – that the reinsurance arrangement has a purpose other than obtaining tax benefits – are insubstantial, inconsequential, or speculative.

Under such circumstances, the Department is entitled to ignore the effect of the reinsurance arrangements and require that the taxpayer report the entirety of the excess value premiums as taxpayer's own income because the taxpayer's reinsurance agreements have no substantive economic substance or business purpose. The plain language of the law states that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect *to all or any part of the taxpayer's business activity* . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." IC 6-3-2-2(l) (*Emphasis added*). The Department is not required to accept the assertion that taxpayer divested itself of a large portion of the highly profitable excess value charges when the divestiture had no economic impact on the taxpayer other than the accompanying tax benefits.

Taxpayer is, of course, entitled to organize its package transport business in any manner its sees fit and to vigorously pursue any tax advantage attendant upon such an arrangement. However, in determining the nature of any business transaction and the resultant tax consequences, the Department is required to look at "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992).

FINDING

Taxpayer's protest is respectfully denied.

II. Combined Water's Edge Unitary Return.

The audit report – completed in 2001 – accepted taxpayer's combined unitary tax returns. However, the audit rejected the taxpayer's decision to file the unitary returns using a worldwide reporting method. As a result, the audit excluded income received from foreign sources because, under a "water's edge" basis, that net income should not have been included on the Indiana returns.

Taxpayer takes exception to the audit's decision rejecting the worldwide method of reporting its income. Taxpayer argues that it has consistently filed its corporate income tax returns on a worldwide basis since 1983 and that this method of reporting has been accepted by the Department during previous audit cycles. In addition, taxpayer maintains that, "there is nothing in the statutes or regulations that requires or permits the Department to reject a worldwide return that is voluntarily filed by the taxpayer and which fairly reflects Indiana income." According to taxpayer, having accepted taxpayer's past worldwide returns, the Department may not now reject the 1996, 1997, and 1998 returns filed on a world-wide basis.

IC 6-3-2-2(q) permits a taxpayer to petition the Department for permission to file a combined return. Specifically, the rule states that, "Notwithstanding subsections (o) and (p), one (1) or more taxpayers may petition the department under subsection (l) for permission to file a combined income tax return for a taxable year." "The basic premise in filing combined/unitary returns is that all activities carried on by separate entitles are part of a single unitary business (one taxpayer)." Ind. Dept. of Rev. Tax Policy Directive No. 6 (1992).

However, IC 6-3-2-2(o) contains a "water's edge" provision directed at the Department. "Notwithstanding subsections (l) and (m), the department may not, under any circumstances, require that income, deductions, and credits attributable to a taxpayer and another entity be reported in a combined income tax return for any taxable year, if the other entity is: (1) a foreign corporation . . . ." IC 6-3-2-2(o).

The rule is then that the Department may never require a taxpayer to file a "worldwide" return although a taxpayer may request permission to do so. IC 6-3-2-2(o), (q).

There is nothing to indicate that taxpayer has either sought or received permission to file a worldwide return as required under IC 6-3-2-2(q). There is nothing to indicate that even if taxpayer had sought permission to file a worldwide return, the Department would have found it appropriate to deviate from the unambiguous statutory aversion to employing the worldwide reporting methodology. IC 6-3-2-2(o) ("The department may not, *under any circumstances require* that income" of a foreign corporation "be reported in a combined income tax return for any taxable year . . . ." (*Emphasis added*). There is nothing substantive to establish that even if taxpayer had sought permission to file worldwide returns, the Department would have determined that the standard apportionment methods – employing a "water's edge" formulation – did not fairly reflect the taxpayer's Indiana income. *See* IC 6-3-2-2(o), (q); IC 6-3-2-2.4. The taxpayer's assertion, that the foreign companies are owned and managed by taxpayer and that "nothing could be more unitary," does not establish that the "water's edge" reporting method fails to fairly reflect taxpayer's Indiana income.

Nonetheless, the plain fact is that the Department has permitted taxpayer to file worldwide returns during previous audit cycles. According to taxpayer, this past acquiescence to the worldwide reporting method – in and of itself – requires the Department to consent to the worldwide reporting method on the 1996, 1997, and 1998 returns. Taxpayer's argument fails because – again – there is no indication taxpayer ever *sought* the requisite permission to file worldwide returns, that the Department ever *granted* taxpayer permission to file on a worldwide basis, or that such a proposed reporting methodology would *more fairly reflect* taxpayer's Indiana income.

In addition, taxpayer is not entitled to prospective treatment of the determination reached within this Letter of Findings because there is no indication that the audit report, completed in 2001, "reinterpreted" taxpayer's then current tax liability. *See* Securities Corp. v. Dept. of State Revenue, 704 N.E.2d 1122, 1129 (Ind. Tax Ct. 1998). To the contrary, information contained within a previous audit report – stemming from a review taxpayer's 1990, 1991, and 1994 returns – specifically noted that taxpayer was incorrectly reporting on a worldwide basis and that this method of reporting was unwarranted. Although the audit did not require the elimination of the foreign income during that particular reporting period, the report noted that "taxpayer has been notified that no future filings with Indiana will be allowed on a [worldwide] unitary basis." There is no indication that there was a statutory basis for permitting worldwide reporting during the previous audit cycles. Taxpayer was placed on notice by at least August 1994 that it would not be permitted to file on a worldwide basis in the future. Taxpayer may not now be heard to complain that it is entitled to prospective treatment of a decision regarding the appropriateness of the worldwide reporting method reached in 2003.

FINDING

Taxpayer's protest is respectfully denied.

III. Unitary Partnerships – Adjusted Gross Income Tax.

Taxpayer filed unitary returns. The audit determined that five partnerships, in which the taxpayer had made investments, should be considered "unitary" with the taxpayer. The audit arrived at

this conclusion because of the partnership's "relationship to parcel shipping or by virtue of the fact that the [t]axpayer exercises control of these [five] partnerships." After arriving at this conclusion, the audit made adjustments to taxpayer's non-business income and to the various components of the apportionment factor.

Taxpayer challenges this decision. Taxpayer argues that the partnerships are simply hands-off business arrangements entered into for the purpose of investing excess cash. According to taxpayer, the five partnerships are managed by unaffiliated companies; all major and minor operational and policy decisions are made by unaffiliated management companies; and that taxpayer's own personnel are not involved in any aspect of the five partnership businesses.

In support of the argument that the five partnerships did not have a unitary relationship with taxpayer, taxpayer cites to 45 IAC 3.1-1-153. The rules states, in relevant part, as follows:

> A corporate partner's share of profit or loss from a partnership will be included in its federal taxable income and therefore generally subject to the same rules as any other adjusted gross income (b) If the corporate partner's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by [the] three (3) factor formula. 45 IAC 3.1-1-153(a), (b).

The Supreme Court has set out a three-part test to determine whether a unitary relationship exists. The three-part test consists of: common ownership; common management; and common use or operation. *See* Allied-Signal Inc. v. Dir., Div. of Taxation, 504 U.S. 768 (1992); F.W. Woolworth v. Taxation and Revenue Dep't of New Mexico, 458 U.S. 354 (1982); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982); Exxon Corp. v. Dep't of Revenue of Wisconsin, 447 U.S. 207 (1980); Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425 (1980).

The first issue to be determined is the question of "common ownership." In this instance, taxpayer owned between 70 to 80 percent of the five partnerships. According to taxpayer, this degree of ownership interest was significant in the audit's determination because the audit excluded two partnerships in which taxpayer owned less than a 50 percent ownership. 45 IAC 3.1-1-153(b) provides no specific guidance as to the degree of common ownership necessary to establish a "unitary relationship." However, taxpayer owns between 70 to 80 percent of the five partnerships and this evidence is sufficient to establish that taxpayer and the five partnerships share "common ownership."

The second element considered in establishing a unitary relationship is common management. Common management is demonstrated when the parent company provides a management role that is "grounded in [the parent company's] own operational expertise and its overall operational Strategy." Container Corp. v. Franchise Tax Board, 463 U.S. 159, 180 n.19 (1983). In determining this second element, the audit report provides no specific information as to the degree of operational control taxpayer exercises over the five partnership interests.

The five partnerships are involved in various business enterprises including satellite ownership, aircraft leasing, oil drilling operations, office leasing, and hotel investments. According to

taxpayer, the aircraft owned by the partnership interest are not leased for use in taxpayer's own package shipping business but are leased to commercial airlines for use in providing passenger service. Given the disparity between taxpayer's business and the five partnership's businesses and the absence of any information that taxpayer exercises any managerial control over the five partnerships, it is reasonable to conclude that the second element – common management – is absent.

The third element is that of common operation or use. Evidence of a "common operation" exists where certain functions are performed for the outside group by the parent (such as purchasing, financing, advertising, marketing, research, tax compliance, insurance, and pension plan management) which entirely independent companies would otherwise perform for themselves.

There is no information that taxpayer and the five partnerships share in any degree of "common operation." Given the information provided by taxpayer – that the relationship between itself and the five partnerships is entirely "hands-off" and that the five partnerships are simply investment vehicles for taxpayer's excess cash reserves – it is reasonable to conclude that the third element, common operation or use, is lacking.

Although the taxpayer possesses a substantial degree of ownership in the five partnerships, because the elements of common management and common operation are entirely absent, the taxpayer is correct in its assertion that, under 45 IAC 3.1-1-153(a), it did not have a unitary relationship with the five partnerships.

FINDING

Taxpayer's protest is sustained.

IV. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer maintains that its "Indiana returns were substantially correct as filed" and that "no penalties should be assessed in this matter."

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . ."

Despite additional assessments determined at the time of the original audit and the issues raised within taxpayer's protest, under the facts and circumstances as indicated in the record, taxpayer has

demonstrated that it "exercised ordinary business care" and is therefore entitled to abatement of the ten-percent negligence penalty.

FINDING

Taxpayer's protest is sustained.

DK/JM/MR – 032002